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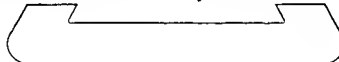


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NSC REVIEW
COMPLETED

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For 9 November PRC on Iran

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SECRET ATTACHMENT

November 6, 1978

MEMORANDUM FOR:

REAC # 4944-78
file PRC

THE VICE PRESIDENT
THE SECRETARY OF STATE
THE SECRETARY OF THE TREASURY
THE SECRETARY OF DEFENSE
THE SECRETARY OF COMMERCE
THE SECRETARY OF ENERGY
ASSISTANT TO THE PRESIDENT FOR DOMESTIC AFFAIRS
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
THE CHAIRMAN, JOINT CHIEFS OF STAFF
DIRECTOR OF CENTRAL INTELLIGENCE

SUBJECT: PRC Meeting on Secretary Blumenthal's Trip
to the Middle East, November 9, 1978

The attached paper was prepared by the Department of State as the basis for the discussion at the meeting. Obviously, the situation in both the Arab-Israel negotiations and the developments in Iran are moving very fast, and some aspects of the paper will no doubt need to be updated in the presentations at the PRC itself.

Christine Dodson
Christine Dodson
Staff Secretary

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PRC MEETING
ON
SECRETARY BLUMENTHAL'S TRIP TO THE MIDDLE EAST
NOVEMBER 9, 1978

AGENDA

1. Regional Context in Which Visit Takes Place
 - a. Saudi Arabia
 - b. United Arab Emirates (UAE)
 - c. Iran
 - d. Kuwait
2. Oil Pricing and Supply
3. Middle East Peace Process

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PRC MEETING
ON
SECRETARY BLUMENTHAL'S TRIP TO THE MIDDLE EAST
NOVEMBER 9, 1978

DISCUSSION PAPER

Overview

Secretary Blumenthal's visit to Saudi Arabia, the United Arab Emirates (UAE), Iran and Kuwait comes at a critical period in our relationships with these countries in a number of major policy areas. The focus of the visit will inevitably be on oil pricing, support for the dollar, and other important economic issues.

In addition to the economic subjects, however, major issues of regional security will be very much on the minds of the leaders in the countries visited. The Secretary goes as a senior member of the Administration to an area in which basic assumptions, which have long motivated US policy toward the region and our relationships with the countries concerned, are facing the dynamics of rapid political change. In all four countries the Secretary must deal with reactions to the Middle East peace process, with concern about the impact of the political problems in Iran on both the stability of the Iranian regime and the security of the broader region, and with a more general concern about US responsiveness to what the states of the area perceive as a Soviet policy of encirclement of the Persian Gulf. The visit, therefore, presents a critical opportunity to project in a credible fashion the confidence of the Administration in dealing with the Great Power responsibility which the US bears.

In the countries to be visited, the leadership will be looking for reassurances about the strength of the American economy, the effectiveness of our anti-inflation program, the prospects for the dollar's recovery, and the efficacy of our energy policy. The Secretary will need to reinforce the perception that there is a strong mutuality of interest between the US as the leader of the industrial world and these countries as the most affluent OPEC

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producers in working together to assure international financial health and economic recovery.

In addition, they will be looking for reassurances that the US is prepared to assert its own positions as a full partner in the negotiating process to achieve a comprehensive Middle East peace. The Shah will, of course, be looking for evidence that US support for the regime in these very troubled times is sustained, and in Saudi Arabia and the Gulf states the leadership will be extremely interested in the constancy of our support for Iran and our assessment of the situation there. Finally, all of the states visited would welcome reassurances that the US, in fulfilling its role as a world power, is alert to Soviet intentions towards the Persian Gulf, dedicated to maintaining the sort of global balance which will continue to deter Soviet penetration of the area, and prepared to continue supporting the states of the region in their efforts to provide for the Gulf's security.

In addition to the fundamental questions of oil pricing and the Middle East peace process, the following issues are of urgent concern to the countries to be visited.

Saudi Arabia

1. Regional Security Issues. Saudi security concerns remain acute. They perceive a Soviet strategy of encirclement aimed at Saudi Arabia. During the last year these perceptions and fears have been fueled by the fighting in the Horn of Africa, the assassinations in North Yemen, the assumption of power by a more rigidly Marxist regime in South Yemen, the domestic turmoil in Iran and the coup in Afghanistan. Their greatest concern has been the stability of the fragile government in North Yemen, but the deteriorating situation in Iran is causing increasing concern.

Growing self-confidence, ability to provide financial aid and the development of a modest but modern defense capability have nurtured constructive Saudi leadership in fostering the security and orderly development of the Arabian Peninsula. Saudi Arabia's policy has been generally

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supportive of our interest in Saudi-Iranian cooperation for the security of the oil-rich Persian Gulf.

For our part, the US has assisted the Saudis to develop their defensive capabilities. The sale of the F-15s was a benchmark in the rapid expansion of our longstanding security assistance relationship. In addition, we have recently agreed to the Saudi request to accelerate and expand our joint program of providing equipment and training to North Yemen.

2. The Dollar. To the best of our knowledge Saudi Arabia has never come out more strongly on an international economic issue than its current support for the US dollar. With a significant portion of Saudi reserves invested in dollars and oil priced in dollars, the Saudis' concern for the dollar and the economic health of the US is very real.

3. Transfer of Technology. Saudi Arabia is generally pleased with the US role in transferring US technology to assist its development program. While most Saudis recognize the role the Joint Commission has played in this regard, some officials have suggested that the Commission has not gone far enough in its activities. It is difficult for the Saudis to accept the limitations which their own manpower constraints place on absorbing technology.

4. US Regulations Regarding Trade and Taxes. Saudis are also concerned by what they perceive as US-erected obstacles to closer US-Saudi private business relationships. They regard our laws and rulings on taxation of overseas Americans as an obstacle to expanding the US role in Saudi development. They are also concerned about US laws and regulations on the Arab Boycott which they regard as hampering trade and investment. Currently they are especially concerned about the IRS Revenue Ruling 78-63 on Foreign Tax Credits on their revenues. This could be eliminated as a factor if the ARAMCO takeover is completed by year's end, but in the view of the shareholder companies this is unlikely.

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United Arab Emirates (UAE)

1. Regional Security As in the case of Arabia, as noted above, regional developments of the past year have caused the UAE leadership great anxiety. This anxiety can become particularly acute because of the UAE government's realization that there is little it can do to effect developments, particularly in Iran. We have stressed to the UAE that its moderate and constructive attitude toward regional issues makes a contribution to the area's stability, and that its own success in developing an effective federation can be a major contribution to this end.

Another regional crisis center, Lebanon, has been a focus of UAE activity. The UAE has constructively cooperated with other moderate Arab states by constructively cooperated with other moderate Arab states by contributing both money and a modest but symbolically important number of troops.

2. International Lending and Investment The UAE has taken an active and generous role in international financial and developmental institutions. Its liberal bilateral lending (and grant) policy to many underdeveloped nations is also noteworthy. The support for Egypt is particularly significant.

Iran

1. The Setting Secretary Blumenthal's visit to Iran occurs at a moment when the Shah's fortunes have never been lower. In almost all Iranian cities demonstrators, predominately college and high school students, clash violently with police and army and openly defy them when they refuse to use force. A wave of labor unrest has touched every sector of the economy causing investment uncertainty, exacerbating capital flight, and contributing to the overall slowdown in growth. Generous wage settlements, designed to buy labor peace, will add possibly \$4 billion to the Iranian budget deficit this year and \$3 billion the next year.

The most serious of the strikes has taken place in the oil industry, Iran's lifeline. A walkout led by white collar staff has caused production to plummet to about 1.5 million barrels per day (It had been running about 5.6 - 5.8 million b/d). Exports, because of the

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stop in production, were less than one billion b/d as of Tuesday, October 31. At this level, Iran will lose about \$50 to \$60 million per day in revenues, or about 95% of gross foreign exchange earnings.

There is some hope that negotiations under way between the government and moderate secular and religious leaders may produce an accord which could end the opposition in the streets and among strikers. There is considerable doubt, however, that the extremist religious leader, Ayatollah Khomeini, will agree to any compromise short of his demand for the end to the Pahlavi Dynasty. Without his acquiescence, there is little prospect that the negotiations will be fruitful.

Senior military officers consider the civilian government ineffective and unnecessarily soft and have talked frankly of a possible move to exert stronger influence, presumably maintaining the Shah as a figure-head ruler. If the situation continues to deteriorate, the military will almost certainly intervene. The military would deal harshly with the opposition, making any arrests, clamping down on the press and suppressing street demonstrations. The counter reaction from the masses would be equally harsh, though possibly somewhat delayed. Plainly, this Administration would find it difficult indeed to support a military regime in Iran.

The Shah has severe long term problems, but also an urgent need to establish effective government within a few weeks. Among all classes there is a new questioning of the Shah's effectiveness and legitimacy. The absolute prerequisite for a restoration of stability is a measure of public credibility in the Shah's regime.

2. What the U.S. Has Done. Secretary Blumenthal's trip to Iran will take place after visits by Under Secretary Newsome, Deputy CINCEUR Huyser, Marine Commandant Wilson and Deputy Secretary Duncan. All of them saw the Shah and conveyed a strong expression of U.S. support. Under Secretary Cooper left Tehran on November 1 after two days of discussions with Iranian officials about the current economic situation. The President telephoned the Shah

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on September 10, mentioned Iran in his press conference one month later, and conveyed his support for the Shah in a personal message on the Shah's birthday, October 26, and in a meeting with the Crown Prince on October 31.

3. U.S. Policy. U.S. policy was stated by Secretary Vance in his press conference of November 3:

--We fully support the efforts of the Shah to restore order while continuing his program of liberalization.

--...law and order can be restored;...at the same time one can continue along the course which the Shah has chartered for himself and for his nation; as you know, he has set forth a plan which would lead to elections in the year 1979; and there is no inconsistency in reestablishing stability within the nation and moving on subsequently to the holding of elections according to his liberalization plan.

4. Secretary Blumenthal's Visit. In support of these objectives, the Secretary's visit will enable us to:

-- offer again Administration support for the Shah in face of his current difficulties;

-- express our interest in and support for the Iranian Government's program of economic reform;

-- examine first hand current economic and financial trends and to assess their implications for political stability; and

-- offer ways in which the U.S. could, possibly through the Joint Commission, extend advice and assistance (on a reimbursable basis) to help the GOI with its economic planning and the rapid implementation of projects with high political impact. The World Bank has also expressed interest in resuming technical assistance activities in Iran on reimbursable basis.

Kuwait

1. Regional Security. The regional security developments of the past year have been deeply disturbing to the Kuwaitis. As noted above for Saudi Arabia and the UAE, the Kuwaitis have been unsettled by the domestic turmoil in Iran as well as the leftist successes in Afghanistan, South Yemen, the

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fighting in the Horn of Africa and the coups in North Yemen. Although Kuwait lacks the political influence of Saudi Arabia among the Arabian Peninsula states, it was an early force for seeking closer cooperation among these states in the interest of overall security and orderly progress. In recent years, since the end of the British Defense Treaty in 1971, Kuwait has entered a significant security assistance relationship with the U.S., and quietly recognizes the importance of the U.S. role in maintaining a global balance and deterring outside intervention in the Persian Gulf.

As with Saudi Arabia and the UAE, Kuwait has played a constructive role among the moderate Arab states seeking to reestablish a stable environment in Lebanon this year. We, of course, share this goal with the Kuwaitis.

2. Other Issues.

a. Oil production levels. Kuwait has roughly a million barrels per day excess capacity. Given the strong conservationist mood in Kuwaiti society, as well as minimal economic incentives to produce more oil, it is doubtful they will increase production in the foreseeable future.

b. International Finance and the Dollar. While the Kuwait role in international finance is generally considered sophisticated and responsible, Kuwaiti leaders feel deeply that the country's interests have suffered as a result of the decline of the dollar.

c. International Development Lending. Kuwait was the first OPEC country to develop sizeable financial surpluses and was a leader in developing lending programs to assist poorer nations. It also has a well-developed and constructive relationship with international developmental institutions.

d. Proposed IRS Regulation Changes. The Kuwaitis are seriously upset about the proposed IRS regulation which would codify rulings of the IRS Code pertaining to the conditions under which the commercial income of a foreign government from sources within the US is exempt from taxation.

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OPEC Price Decision

There are strong pressures within OPEC for an oil price increase of at least five percent at the December 16 OPEC meeting in Abu Dhabi. Every OPEC member is on record, officially or unofficially, favoring a price increase. Amounts vary from Iraq's call for a 25% increase [redacted] that the Saudis will agree to an increase of 2-7%. The U.S. has made informal approaches to governments of OPEC and OECD countries pointing out the adverse economic impact of an oil price increase at this time. Responses received so far from OPEC capitals have supported the view that a price increase of at least five percent is likely. OECD capitals have generally agreed with the U.S. analysis of the adverse impact of a price hike on growth, inflation, and trade balances. At the same time, these countries have indicated reluctance to play an active role in seeking to prevent a December price hike.

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Secretary Blumenthal during his Middle East trip could most usefully seek to obtain a clear indication of the Saudi position on oil price and respond appropriately. In the unlikely event that the Saudis are prepared to support a continuation of the 1977-78 price freeze, Secretary Blumenthal should indicate that the U.S. is very appreciative of the Saudi position and is prepared to assist the Saudi effort by additional representations to key countries.

If, as is more likely, the Saudi's indicate that they are committed to a price increase, Secretary Blumenthal should ascertain the amount of increase which the Saudis will accept and point out that:

- U.S. recognizes mounting pressures within OPEC which have led to this decision by Saudi Arabia.
- U.S. understands that concern over loss of purchasing power by OPEC as the dollar has depreciated against several important currencies has been the main reason for OPEC pressures.
- U.S. believes that even so-called "moderate" increases will impose a significant economic burden on oil-importing countries -- both developed and developing.
- U.S. believes that prospects for appreciation of the dollar are good for several reasons: (1) measures announced by the U.S. on November 1; (2) U.S. energy legislation, which will restrain growth in demand for oil significantly; (3) a major effort by the U.S. to

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reduce inflation and increase exports; and (4) the reflation of the other OECD economies.

- U.S. questions whether an oil price increase would do much to restore OPEC purchasing power since it would have an adverse impact on the programs of the U.S. and other countries seeking to ameliorate structural problems which contribute to inflation and currence instability.
- Since any oil price increase will have potentially adverse impacts on global economic and financial stability, the U.S. urges that prices be raised no more than 5% for the entire year, preferably with the effect mitigated by phasing over the year. The U.S. could accept this outcome as responsible under the circumstances.

Secretary Blumenthal should attempt to elicit an understanding from the Saudis regarding oil prices for the full year even though the Saudis might prefer to leave the matter of post-January increases open. Secretary Blumenthal's role publicly and in Iran, the UAE, and Kuwait will be largely dependent on the Saudi's position. Obviously, in the unlikely event that the Saudis opt for a continued freeze, the Secretary's role will be to build support for this decision. The Secretary should plan to make strong demarches in Iran, Kuwait and the UAE if this is consistent with Saudi advice.

More likely, the Secretary will have to try to minimize a price increase by presenting the U.S. case to those countries in terms of the potentially adverse global economic and financial impact of any price hike. If appropriate to the political situation existing at the time in Iran, the Secretary could repeat the arguments made to the Saudis for limiting any price hike, pointing out the maximum price hike which the U.S. could consider responsible. Unless the Saudis suggest that it would be desirable for him to seek the agreement of the UAE and Kuwait to a specific figure, he should leave this task to the Saudis and concentrate on delineating for those governments the adverse impact of any price hike. Premature or public acquiescence by the U.S. to a moderate price increase could lead to an uncontrollable process resulting in an unacceptable price increase.

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Middle East Peace Process

The status of the peace process and the results of the Arab Summit will be reported at the PRC meeting. As of this writing the positions of the countries are as follows:

1. Saudi Arabia: We have been in close contact with Saudi decision-makers at all levels; most recently the President lunched with King Khalid in Washington on October 27. The initial Saudi reaction to the Camp David agreements was reserved. The Saudis are deeply concerned about political divisions in the Arab world and feel they will be under great pressure to defend their ties with the US and Sadat. They initially conditioned their support for Camp David on a number of unrealistic requests: direct US contact with, and recognition of, the PLO; direct linkage of the Egyptian-Israeli treaty with Camp David framework agreement and the West Bank/Gaza negotiations flowing from it; and assurances that at the end of the five years there will be Israeli withdrawal and Palestinian self-determination. More recently, in private conversations with Ambassador West, Crown Prince Fahd has moved significantly to a position of support for the Camp David process. We are hopeful that that private position will increasingly be reflected in public Saudi positions. There is already some evidence of the Saudi shift in its consultations with the smaller Gulf states prior to the Baghdad meetings.

2. United Arab Emirates: Despite its importance as an Arab financier, on a political issue of such magnitude in the Arab world as Camp David, the UAE carries little weight. To date its public and private positions have reflected restrained criticism of the Camp David Agreements and a non-committal attitude toward eventually supporting Jordanian and Palestinian participation in the negotiations. The UAE clearly will not get out in front of Saudi Arabia in support of Camp David.

3. Iran: The Shah has indicated his understanding that Sadat has no choice but to move forward toward peace with Israel, and he has assured Sadat of his support. While the Shah would like to be helpful to us on this issue and warmly endorsed the President's efforts, he remains somewhat skeptical about the eventual success of the agreement. He is, of course, particularly aware of the

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strategic implications of Camp David for the Middle East generally, and is concerned that divisions in the Arab world would permit new Soviet inroads.

4. Kuwait: The Kuwaitis have taken the position that the Camp David framework is inadequate in its assurances of Palestinian rights. Traditionally Kuwait tries to stay on a non-controversial, middle-of-the-road path in inter-Arab affairs. Being essentially moderate, Kuwait feels under enormous pressure in the present Arab political environment. Even under the best of circumstances--public Saudi support for Camp David--it is highly unlikely that the Kuwaitis will get off the fence in our support, and their public position will probably remain one of criticism of the Camp David agreement.

TAB